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**(Attachment to Reply Comments of**  
**The National Cable & Telecommunication Association)**

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**I. Introduction**

We have been asked by the National Cable Television Association to evaluate the economic arguments set forth in the comments of the Consumer Federation of America et al (“CFA”)<sup>1</sup> in response to the Commission’s Further Notice of Proposed Rulemaking in this proceeding.<sup>2</sup> Our curriculum vitae are attached as Exhibit A. The premise of a limit on cable concentration at the national level is that the market in which cable operators

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<sup>1</sup> Comments of Consumer Federation of America, Consumers Union, Media Access Project, Center for Digital Democracy, The Office of Communications of the United Church of Christ, Inc., Association for Independent Video and Filmmakers, National Alliance for Media Arts and Culture, and the Alliance for Community Media, filed January 4, 2002.

<sup>2</sup> *Further Notice of Proposed Rulemaking* In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission’s Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission’s Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of Commission’s Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission’s Cross-Interest Policy, Dockets, CS 98-82, 96-85, MM 92-264, 94-150, 92-51, 87-154, rel. Sept. 21, 2001, (“Further Notice”).

purchase video programming is national and, therefore, that the performance of that market could be affected by national consolidation among downstream purchasers of that programming. Such concentration of program purchasers raises the specters of monopsony power and of vertical foreclosure and discrimination strategies, which were the concerns that motivated Congress to enact section 613 of the 1992 Cable Act. Insofar as CFA argues in its comments that the national cable market is relevant to this proceeding, therefore, we agree.

We disagree with CFA, however, on several key points. First, we find it unlikely that in current market circumstances even very large cable operators would have the incentive or ability to engage in such harmful vertical conduct in the video programming market. Second, we disagree with CFA's application of antitrust precedent and analytic tools relevant to examining the effects of mergers of competing firms on downstream market power (*i.e. monopoly* power) to the examination of how mergers of non-competing firms will affect upstream market power (*i.e. monopsony* power). Third, the likelihood and degree of monopsony power cannot be understood by reference to the national market alone and without understanding the competitive structure of the local market for MVPD services. And finally, we find the factual premises underlying CFA's claims about MVPD market concentration, the lack of competition from DBS, and the likelihood of vertical foreclosure and discrimination in program supply to be incorrect and disputed by the empirical evidence.

In this filing we first examine the relationship between cable concentration at the national level and economic performance of the video programming market. Both theory and empirical evidence suggest there is little incentive or ability for large cable firms to

exercise monopsony power or to engage in vertical foreclosure in their procurement of programming. In section III we discuss the local cable market and explain how local competition affects monopsony behavior at the national level, why CFA's antitrust analysis does not demonstrate monopoly power in the local MVPD market, and why the empirical evidence contradicts CFA's assertion that DBS does not compete with cable for local subscribers. Finally, section IV summarizes our findings and concludes that a stringent horizontal ownership cap on cable operators is not warranted.

## **II. The Major Concern in this Proceeding is the National Market for Video Programming**

The focus of the Commission's Further Notice is appropriately centered on how the horizontal ownership rules will affect the national market for video programming. However, much of CFA's analysis instead focuses on the market for retail MVPD services and the horizontal structure of that market. When CFA does finally discuss vertical issues related to programming, it addresses the risks of foreclosure and discrimination that might arise from vertical integration between cable operators and program producers but virtually ignores the issue of monopsony power so central to this proceeding. In this section, we assess the economic incentives that may give rise to concern about monopsony power from cable concentration on a national level and look at the performance of the national programming market to see if there is any evidence of monopsony harms. We follow this section with an examination of how the structure of local cable markets affects the behavior of cable operators at the national level in their procurement of video programming.

*A. Vertical Issues -- Monopsony and foreclosure*

Vertical issues lie at the heart of the Commission's mandate to impose a limit on cable ownership, but CFA's filing discusses only in very general terms the definition of, and possible harms from, monopsony power, quoting at length passages from general treatises on economics. CFA devotes most of its vertical market discussion to issues of foreclosure and discrimination, which, though relevant to this proceeding, relate more directly to vertical integration than to horizontal concentration.<sup>3</sup>

The distinction between monopsony power and other vertical conduct is important to this proceeding and its ultimate purpose of determining an appropriate horizontal ownership limit for cable operators. The theory behind the ownership limit currently under consideration is directly related to the accumulation of buying power in the upstream market for video programming. Wholesale cable programming is sold to cable operators in a national market, and the operative concern of section 613 is that downstream concentrations of those cable operators might give them monopsony power in their interactions with programmers.

The correspondence between downstream concentration and upstream monopsony power is not a simple one, however, and no presumption can be made that a large buyer will have either the incentive or ability to behave monopsonistically. Indeed, while national concentration might give large cable operators additional bargaining

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<sup>3</sup> To support its position, CFA quotes substantially from an article about the possibility of content and conduit discrimination. That article was written as an analysis of the AOL/Time Warner merger, a vertical merger that has little to do with the examination of horizontal ownership limits. That article and the subsequent theory addressed possible situations in which a vertically integrated firm might want to use its control of content to disadvantage rivals at the downstream level and where a downstream firm could weaken other upstream suppliers through refusing to accept programming. Both of these were posed as theories in the article without evidence of actual discrimination or foreclosure.

power in their dealings with programmers, it is unlikely that such buying power would go beyond simply getting a better deal and extend to the exercise of harmful monopsony.

To begin, we note that at a general, background level, much less is known about the relationship between concentration and monopsony power than is known about the relationship between concentration and monopoly power. But even if one assumes that the DOJ/FTC Horizontal Merger Guidelines can be applied to monopsony just as they apply to monopoly, the prospects for national concentration among cable operators to create harmful monopsony power are weak.

Indeed, it is unlikely that even a very large cable operator would have either the incentive or ability to exercise buying power in a way that damages the flow of diverse, quality programming to consumers. Consider first the *ability* of a cable operator to harm quality and output in the programming market. To do so, an operator would have to be sufficiently large that the demand for programming of the remaining operators is insufficient to support a well-functioning program production market. If one were to imagine, for example, a cable operator that serves 50 percent of current MVPD subscribers, in today's market that would leave nearly 45 million MVPD subscribers served by other operators. To argue that a given level of ownership could create purchasing power that will damage program production market-wide, one must be able to show that competing demand for programming cannot offset that harm. There is no such analysis or empirical support anywhere in CFA's filing.

Even if one found that a cable operator did have the ability to exercise monopsony power, the analysis of vertical market performance could not rest there. The operator's incentives actually to use such power must also be examined. For example, if a cable

operator faces a downstream rival that can offer subscribers higher-quality programming or the same programming at a lower price, then the cable operator's incentive to exercise monopsony power in a harmful manner is greatly diminished. To be sure, any firm will try to use whatever purchasing power it has to obtain lower prices and gain a greater share of the rents to be allocated between buyer and seller. But that is very different from causing the kinds of social harms — reduced output and quality — that are generally ascribed to monopsony. If a cable operator were to exercise monopsony in such a manner, it would lose customers to DBS rivals who can purchase more, and higher quality, programming and thereby take market share from cable. We will return in more detail to the effect of downstream competition on upstream monopsony in part III.

The incentive of cable operators to act monopsonistically is further weakened by the fact that programs are non-rivalrous goods. One operator's distribution of a program does not interfere with the ability of another operator to disseminate the same program. And the broader the distribution of a program, the more its fixed production costs can be spread. This has the consequence of diminishing a large operator's incentive to use its buying power to exclude others from distributing the same program. In addition, it means that while a cable operator on one hand might pocket little from driving the program market towards less, and lower quality, programming, it on the other hand would not bear the full costs of successful, high-quality programming that is widely carried.

In the end, CFA offers scant analysis logically to connect a horizontal ownership cap to the reduction of harms from monopsony conduct. Monopsony was, of course, one of Congress' principal concerns in enacting section 613 and directing the FCC to consider a reasonable ownership limit for cable operators. This section has tried to

demonstrate just how difficult and unlikely it would be for a cable operator to use its buying power to cause the harms conventionally ascribed to monopsony. If the cable operator were not large enough to dictate the nature of programming for the market as a whole, then the large cable operator would face competition from rivals who, in the effort to attract subscribers from cable, purchase better quality programming than what the cable operator has purchased. In the final analysis, there is arguably little ability for a large cable operator to act monopsonistically, and little incentive for it to do so where it can.

***B. The national programming market is very dynamic***

The FCC notes that “[a]dditionally, the Commission must consider the evolving and ‘dynamic’ nature of the communications marketplace, as Congress recognized that alternative services and technologies are being, and will be, introduced.”<sup>4</sup> There are at least three significant empirical changes over the past few years that CFA fails to account for in its analysis: the rise of DBS as a local competitor and participant in the national programming market; the upgrades of cable systems; and the vertical disintegration that has occurred between the cable industry and the programming industry.

Looking at the data several years ago, one would not have found either EchoStar or DirecTV in the top 8 purchasers of video programming. Now both are in that category. Just simply looking at the changes in Table C-3 from the 7<sup>th</sup> Cable Competition report to the 8<sup>th</sup> Cable Competition report shows their growth. DirecTV gained 1% *share* of the national MVPD market and EchoStar gained more than 1.5%. Together, the two DBS

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<sup>4</sup> Further Notice, para 6. [footnotes omitted].

firms have gained about 2.8% share of MVPD customers in the past year alone. They have gone from zero market share to over 18% in 7 years so the increase in the past year is not out of line with their increases in share over their entire history.<sup>5</sup> Since cable had virtually 100% share of MVPD customers in 1994, the gain for the DBS providers has come at the expense of cable; cable has lost 18% share in the past 7 years. As DirecTV and EchoStar continue their rollouts of local channels, and as more people become aware of the possibility of getting local signals directly from EchoStar and DirecTV, the two DBS firms serve as a serious competitive threat to both local cable television systems and as a threat to any perceived national purchasing power on the part of cable systems.<sup>6</sup>

CFA claims that the national program market is highly concentrated, but is forced to change substantially the FCC's reported figures to get this result. CFA's Exhibit VIII-1 purporting to show high concentration in national program acquisition contradicts economic logic and is at odds with FCC data.<sup>7</sup> The FCC's figures show that acquisition of national programming is not concentrated.

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<sup>5</sup> According to the FCC 8<sup>th</sup> Cable Competition Report, Table C-1, "Assessment of Competing Technologies," together the two DBS firms have gained well more than 2% of MVPD share in each year since 1997.

<sup>6</sup> It is curious to note that CFA has filed in support of the merger of EchoStar and DirecTV. If one believes CFA's story that program acquisition is concentrated and the local markets have limited competition, it is hard to develop a logical reason why they would support the merger of the two firms that are the fastest growing program purchasers and serve as the most significant independent competitors at the local level in most areas.

<sup>7</sup> CFA assumes that AT&T not only controls its own cable systems, but also controls programming decisions of the Time Warner and Cablevision cable systems. Unless AT&T and Time Warner and Cablevision cable systems put on the same channels on their cable systems and have similar interests in program production, or if AT&T has a controlling interest measured in some reasonable manner that would equate with ability to influence significantly programming decisions, it does not make economic sense to attribute ownership in this way. Also, CFA's table is somewhat confusing because the 7<sup>th</sup> Cable Competition Report (the most recent citation for data used in the table) lists concentration as of 1999, yet the table lists concentration as of 2000 and 2002 (we assume that 1889 is a typo meaning 1989). In fact, even the recently released 8<sup>th</sup> Cable Competition Report lists only 2001 statistics, not 2002. Also, the notes in the CFA table say that it attributes "1.6 million TW and 4.3 million Cablevision subscribers to AT&T." Since Cablevision has substantially fewer than 4.3 million subscribers, this appears impossible. We were



In chapter XI of its submission, CFA claims that DBS service is not a substitute for cable and therefore cannot be a substitute for the cable eyeballs in the national programming marketplace. This claim is problematic for two reasons. First, even if DBS served a completely separate and unique set of subscribers, DBS providers would still participate in the market for program acquisition. Second, contrary to CFA's assertions, DBS actually does compete for eyeballs with cable and therefore is a direct substitute.

Because program suppliers have the option to sell to DBS providers, DBS clearly plays an important role in the program acquisition market. In fact, discounting the DBS providers from the program acquisition market would eviscerate any logic behind CFA's overall argument.

Another way to think about DBS providers, if they indeed serve a completely separate market, would be akin to thinking of them as an adjacent cable system. If CFA believes this non-competition story, and believes that the logical conclusion is that EchoStar and DirecTV have no effect on the program acquisition market, it would also have to believe that AOL/Time Warner has no effect in the program acquisition market because AOL/Time Warner and AT&T serve geographically distinct groups of customers at the retail level. CFA concludes that a stringent national horizontal cap is appropriate, but the reasoning CFA uses to exclude the two DBS providers would mean that there is no need for a cap.

The second problem with CFA's discounting of DBS is that DirecTV and EchoStar do in fact compete with cable and with each other for eyeballs in the national programming market. And, as will be shown in the next section, the two DBS providers

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unable to replicate CFA's analysis because we cannot discern from where CFA acquired the data nor how CFA manipulated that data.

provide competition in local markets as well. CFA's discounting of DBS as a competitive factor in the national programming market is inappropriate and unfounded because DBS providers compete both nationally for programming and locally for customers.

***C. The supply of programming shows no sign of anticompetitive abuse***

One of the purported goals of a national ownership cap would be to ensure the competitiveness of program supply. And just as the purchasing side of the national program market has changed with the entry of EchoStar and DirecTV, so too the supply of programming has changed over the past few years in response to entry, cable upgrades, increases in MVPD subscribers and other factors.

One indicator of a vibrant program supply market, but by no means a dispositive one, would be the presence of substantial amounts of unaffiliated programming. The data show that the programming market has seen vigorous entry by unaffiliated programmers and as well as divestiture of proprietary programming by cable companies. This evidence is consistent with a well functioning marketplace and is inconsistent with the tightly controlled programming market CFA attempts to portray.

To support its claims, CFA follows its calculation of national cable concentration in section VIII with a section describing alleged incidents of discrimination against new entrants in their access to programs. Yet these anecdotal examples neither prove CFA's foreclosure point on their own terms nor refute the hard empirical evidence contradicting CFA's assertions about vertical conduct. It is certainly likely that in some cases new entrants have not been able to acquire programs on as beneficial a basis as they would like. It is also possible that there have been instances where entrants have not gotten as

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good a deal as incumbent cable operators who signed up earlier. But a few isolated examples cannot be the basis for regulation when the evidence about vertical market performance is otherwise, and there may moreover be a variety of explanations on both sides of the issue for the alleged examples of discrimination that CFA does identify.

The first step in understanding whether vertical foreclosure and discrimination are a genuine problem is to think about the theoretical predictions of how increased horizontal concentration in cable might affect the program supply market. Under the foreclosure theory, large integrated cable operators/programmers should be able to shut out unaffiliated programmers. Other commenters in this proceeding have analyzed this theory.<sup>8</sup> They show that the foreclosure theory has a large Achilles heel – as cable operators get larger, they sacrifice more in lost profits from foreclosing than they gain by charging higher prices to unaffiliated MVPDs.

If the CFA's foreclosure or monopsony theories were correct, and if its data on increasing concentration were also correct, there should be a small and diminishing share of programming provided by non-affiliated networks.<sup>9</sup> Others have analyzed this question and concluded that there is little support for this outcome.<sup>10</sup> We provide some additional evidence from the FCC's recent 8<sup>th</sup> Cable Competition report that shows a very different marketplace than one would find if foreclosure were occurring.

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<sup>8</sup> *See for example*, Declaration of Janusz A. Ordoover on behalf of AT&T Corp. attached to the comments of AT&T in this proceeding.

<sup>9</sup> It should be strongly noted that this is a one-way test. Evidence of a vibrant market for unaffiliated programming provides evidence that foreclosure is not occurring. Evidence of a large degree of vertical integration is not dispositive evidence of foreclosure – it may be that the benefits of integration align incentives more closely.

<sup>10</sup> *See* Declaration of Stanley Besen attached to the comments of AT&T in this proceeding and Paul Joskow and Linda McLaughlin, "An Economic Analysis of Subscriber Limits" attached to the comments of Time Warner Cable in this proceeding.

The FCC's 8<sup>th</sup> Cable Competition report lists 243 national networks in tables D-1 and D-2. 85, or 35%, have some cable ownership. The remaining 158, or 65%, have no cable ownership.<sup>11</sup> Looking at these 243 national cable networks, in every year since 1994 the integrated cable networks constituted a minority of the new introductions.<sup>12</sup>

Table D-6 of the FCC's report shows the top 20 programming services by subscribership. CFA claims support for its theory in that slightly less than half of the top 20 cable networks as measured by subscribers have some ownership by major cable MSOs. Is the glass half-full or half-empty? Another way to look at the data is that more than half of the top 20 networks are not listed as being vertically integrated. In addition, only 4 of those have 100 percent cable ownership, those owned by AOL/Time Warner.<sup>13</sup> In addition, there has been change in the past year. The most recent Kagan data listed on the NCTA website shows that all of the top 20 programming services, both affiliated and unaffiliated have increased subscriber levels.<sup>14</sup> There has also been change in the relative rankings, as some unaffiliated programming services have increased subscribership more rapidly than affiliated programming services. This is the opposite of what foreclosure or monopsony would predict.

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<sup>11</sup> Actually, the unaffiliated programmers may be significantly understated in these figures because even after its spin-off from AT&T, Liberty Media is counted as an MSO because of its ownership of cable systems in Puerto Rico. Thirty-two of the programming services list Liberty Media as the sole MSO owner. If those were counted as unaffiliated, only 22% of the programming channels would be affiliated.

<sup>12</sup> In 1994, Liberty Media introduced a number of new national networks. Liberty Media is no longer part of AT&T so even those programs are no longer affiliated with a major cable operator. Using the figures from only one report leaves open the problem of survivor bias. However, if the CFA theory were correct, the survivor bias should lead to more surviving affiliated programmers so the bias would be against finding unaffiliated programmers.

<sup>13</sup> The same problem of counting Liberty Media as an MSO occurs here – they are listed as an MSO and have the largest MSO ownership share in 3 of the top twenty programming services listed in Table D-6.

<sup>14</sup> [http://www.ncta.com/industry\\_overview/top20networks.cfm?indOverviewID=59](http://www.ncta.com/industry_overview/top20networks.cfm?indOverviewID=59) (accessed 2/15/02).

The continuing entry and continuing success of unaffiliated programming providers provides evidence that unaffiliated programmers understand that there is a profit opportunity in introducing new services.

Also, the fact that there are 243 national programming channels and numerous regional channels, as well, of course, as local over the air broadcasters, means that every cable system will have to choose not to carry some programming because no system has that many channels available. As a result, there have to be instances where programming services are not carried and programmers are disappointed. Some unaffiliated programmers will be displaced by affiliated programs and vice versa. This alone cannot lead to any conclusion about problems in the program market.

If cable operators were able anticompetitively to benefit from vertical integration, spinning Liberty off from AT&T would have caused them to forego such benefits. The more logical explanation is that there is a good market for independent programming services. One explanation for the increased demand for programming, and hence unaffiliated programming as well, is due to the introduction of digital cable service and expanded subscribers on DBS. The vast increase in the number of channels needing to be filled, and the expectation of even greater capacity in the future, has fueled the demand for programming. And the market has responded to this increased demand.

If CFA's theories were correct, one might expect to find regional concentration in ownership of regional cable programming networks because of the clustering of cable systems. There are substantial pro-competitive reasons one might expect to see such ownership as well – the cable systems have strong incentives to show content that appeals to their customers who might exhibit regional differences and demand specific content.

But, according to the 8<sup>th</sup> Cable Competition report, Table D-3, such correspondence between ownership of regional distribution and regional content does not appear to exist. Cablevision apparently owns a minority position in the regional Fox Sports Networks and some other programming, but, with the exception of news channels, its ownership of regional content does not correspond very well to its cable operations. Other cable MSOs clearly do not dominate regional channels.

***D. CFA's application of PNB is inapposite***

CFA is no more successful in finding a legal mandate for a 30 percent cap than it is in finding an empirical market-failure rationale. CFA argues that the Supreme Court's 1966 decision in *U.S. v. Philadelphia National Bank*, 374 U.S. 270 (1966) effectively requires the Commission to adopt a cable ownership limit of no higher than 30 percent. As a doctrinal matter, we note that much has happened in merger policy since the Court decided *Philadelphia National Bank* (*PNB*) more than 35 years ago. Although courts may still sometimes cite *PNB* for its presumption against mergers that produce 30 percent market shares, in neither *PNB* nor any of the cases that follow it is that presumption anything close to absolute. Indeed, even were the rule as strong as CFA suggests, many mergers since the Supreme Court's case would have been prohibited. Moreover, whatever guideline may have been set out (although not mandated as a matter of Supreme Court precedent) in *PNB* is not the basis on which the antitrust agencies base their enforcement decisions. For the past twenty years, they have used the DOJ/FTC merger guidelines, which rely on changes in the HHI and other market factors, not arbitrary market-share cutoffs, to evaluate mergers.

There is no applicable legal presumption from antitrust law strong enough to drive the horizontal ownership limit CFA wants, especially in light of the data already discussed in this section. Indeed, all of the available evidence, when viewed in terms of the fears posed by the CFA's theories of harmful vertical conduct, points to a competitive and dynamic programming market rather than one that is subject to foreclosure or monopsony. The evidence on this put forth by CFA is either inapplicable to the theories it is trying to pursue or contradicts its conclusions.

### **III. Assessment of Local Competition and its Effect on Upstream Monopsony**

The previous section has shown that there is little to worry about in terms of national concentration – the programming market appears to be working well. But even if one disagrees with that conclusion, whatever problems one might find with the market for programming cannot be chalked up to national concentration among purchasers of that programming. For one cannot understand a firm's incentive or ability to engage in harmful vertical conduct in the upstream input market without understanding that firm's horizontal market power in the downstream market in which it sells its final product. The next step of the analysis must therefore be to examine market power in cable services at the local level. Indeed, local horizontal market issues are relevant to the monopsony issues currently before the Commission because for a firm to exercise monopsony power in programming it must have both buying power at the national (input market) level and selling power at the local (retail market) level. Without local market power, there is nothing for a firm to leverage into a monopsony position in the input market.

To illustrate this point, assume for the sake of argument that a large cable operator could exercise purchasing power to decrease the quantity and quality of programming

market-wide, so that no rivals could purchase better programming than the cable operator. The cable operator's incentive actually to exercise such buying power diminishes in the presence of competition. Because cable operators face competition from at least two DBS competitors in local markets, reducing the quality and diversity of available programming through monopsony would be unlikely to yield gains for the cable operator. Such monopsony conduct would not get rid of cable's local rivals, but instead would reduce competition based on differentiated programming and increase competition on price, the dimension of program quality being foreclosed by the cable operator's monopsonistic behavior. But, as the MVPD competitors vie for subscribers by lowering prices, any rents the large cable company gained from its monopsony conduct upstream would likely be dissipated, and this is especially harmful to operators in an industry with high fixed costs. Monopsony has yielded little to the cable operator individually, and may have hurt MVPD providers collectively by making their video services less attractive to existing customers and less likely to entice new subscribers.

With little to gain from exercising monopsony power to degrade program choice and quality, cable and DBS companies are likely to compete not just on price, but on programming as well. The incentive of a large cable operator will more likely be to get the best programming it can to maintain and grow its local market share. This competitive pressure is not merely hypothetical. Contrary to CFA's argument, the local MVPD market has become much more competitive in recent years, creating incentives for cable operators to procure better, not worse, programming and thus eliminating monopsony as a rational strategy. The next section turns to the evidence demonstrating the increase in local MVPD competition.



***A. Local cable markets have become less concentrated, not more concentrated***

CFA's filing does not address the important relationship between local MVPD market structure and monopsony power, perhaps because CFA presumes that its statements about increased cable concentration at the *national* level apply equally to the *local* market. CFA thus argues that there is no competition at the local level that could discipline the vertical market power it claims arises from concentration at the national level. The error in CFA's analysis is illustrated by its inability to reconcile its assertion that the cable market has become increasingly concentrated with the fact that no cable subscriber faces less choice than she had 10 years ago. Indeed, the majority of subscribers now have greater choice: most households can now select among at least three MVPD providers whereas they previously had only one. Not only have the two DBS providers become large players in the program acquisition market, as discussed above, but they have done so by virtue of their success at garnering local subscribers.

CFA discounts the effect of DBS on the MVPD marketplace. However, many of CFA's assertions about the characteristics of DBS that lead it to the conclusion that DBS does not compete with cable are unsupported or out of date. It is true that DBS was not an important factor in either local competition or the national programming market in 1992 when Congress passed the Cable Act. But much has changed since then that contradicts the claims in CFA's submission.

For example, CFA claims that DBS has high upfront costs and costs more than twice as much as cable does. Looking at the Dish Network and DirecTV websites and in numerous newspaper and radio advertisements, one can find many packages that are in the \$30 dollar range, very comparable to the national cable averages and for packages comparable to the expanded basic service that CFA's so-called "lunch bucket" cable

subscribers pay for. Also, both firms and many retailers offer package deals or lease plans to minimize or eliminate the upfront cost of subscribing to DBS service. Competition has reduced these upfront costs substantially over the past few years.

As discussed above, DBS' share of the MVPD market has increased substantially each year. The two DBS firms appear to be continuing to offer the types of services that will appeal to customers – more local channels in addition to their historical fare and other new features. The two DBS companies have just recently begun offering all local channels in more than 40 markets and both have plans to increase the number of markets with local channels whether or not their merger is approved. The introduction of local channels has apparently substantially increased their numbers of subscribers. DirecTV reports that its overall subscriber levels have increased by 20 percent due to local broadcast channel service, and that 47 percent of its customers to whom local broadcasts are available take a local channel package.<sup>15</sup>

The FCC has documented the rapid growth of DBS service and the competition between DBS and cable in its annual report:

“DBS appears to attract former cable subscribers and consumers not previously subscribing to an MVPD. The continued growth of DBS is, in part, attributable to the authority granted to DBS operators to distribute local broadcast television stations in their local markets by the Satellite Home Viewer Improvement Act of 1999 (“SHVIA”). Between June 2000 and June 2001, the number of DBS subscribers grew from almost 13 million households to about 16 million households, which is nearly two and a half times the cable subscriber growth rate. DBS subscribers now represent 18.2 percent of all MVPD subscribers.”<sup>16</sup>

The competition between cable and DBS is expected to continue as DBS makes more inroads with subscribers in cable areas. “Paul Kagan Associates predicts that total

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<sup>15</sup> 8<sup>th</sup> Cable Competition Report, para 59 citing comments of DirecTV at 12-13.

<sup>16</sup> 8<sup>th</sup> Cable Competition Report, para 8.

DBS subscribership will increase to almost 26 million in 2005 and to over 28 million in 2010, a compound annual growth rate of 7.1 percent.”<sup>17</sup> This increase in subscribership can only come from two areas – households that did not subscribe to MVPD service previously or households that previously subscribed to cable. The Yankee Group reports that more than half of DBS subscribers and even more of the new DBS subscribers as of June 2000 had previously been cable subscribers.<sup>18</sup> Rather than serving distinct groups of customers, an overlap of more than 50% is evidence of direct competition.

CFA submits results of its own survey to support its contrary position.<sup>19</sup> CFA claims that there is a group of “lunch bucket” cable subscribers consisting of 42 million subscribers that subscribe only to expanded basic cable and therefore do not face any real competition from DBS providers. There are several problems with CFA’s conclusions. First, there is no evidence presented from the survey that would allow one to come to any conclusion about whether there is competition between cable and DBS. On the contrary, the Yankee Group survey results are applicable and show that most DBS subscribers had previously been cable subscribers, contradicting the CFA conclusion.

Second, even if CFA’s particular group of “lunch bucket” cable customers did not face competition from satellite providers, they could well be protected by the competition that exists to attract other customers. It is well known in antitrust economics that even if some customers have no alternative to a particular good or service, they may not be

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<sup>17</sup> 8<sup>th</sup> Cable Competition Report, para 56. citing Paul Kagan Assocs, Inc., *The State of DBS 2001* (“DBS Databook”), Dec. 2000, at 5.

<sup>18</sup> “DBS Subscriber Study 2000,” The Yankee Group.

<sup>19</sup> Survey results are extremely sensitive to the samples and wording of questions. CFA presents no support to allow us to assess the validity of their survey. However, the CFA sample seems skewed as Exhibit X-2 has 1228 satellite owners and only 679 cable subscribers.

subject to excessive pricing because of the seller's inability to identify them and set high prices that apply only to them but not to the customers who do have a choice. There may be ways for both cable and DBS providers to offer different tiers of service to try to segment demand in some ways, but the competition between the two DBS providers and incumbent cable systems (and in areas where they exist, overbuilders) makes such segmentation less effective at extracting consumer surplus. Since DBS is competing for cable subscribers, especially with the introduction of local signals and low price packages, it is difficult for cable providers specifically to target only those who would not switch to DBS. Also, segmentation can increase total output, the opposite of the social problem from monopsony.

The few serious econometric studies of DBS and cable substitution have all been done without the relatively recent introduction of local channels on DBS service.<sup>20</sup> As a result, their findings will not incorporate what most observers and market participants have found to be a compelling change in DBS service offerings. For example, with the introduction of local signals, in the San Francisco Bay Area there has been a substantial increase in radio and television advertisements by both AT&T and EchoStar targeting each other. EchoStar is offering installation and 3 months of free service for \$50 with a 1-year commitment. In their ads, they target cable subscribers by saying that you don't need cable to get local channels or use multiple sets. On the flip side, AT&T has been running ads saying that their cable service is better than satellite service.

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<sup>20</sup> See for example, Goolsbee, A. and Petrin, A. "The Consumer Gains from Direct Broadcast Satellites and the Competition with Cable TV," working paper January 2002; GAO, "The Effect of Competition from Satellite Providers on Cable Rates," July 2000; Hazlett, T. and Spitzer, M. *Public Policy Toward Cable Television*, 1997 MIT Press, Crandall, R. and Furchtgott-Roth, H. *Cable TV: Regulation or Competition?*, 1996 Brookings.

Even the CFA data, with the caveats about the efficacy of the survey, provide some support for the notion that the competitive landscape is changing. About 11 percent of the survey respondents take both cable and satellite service. And CFA asserts the reason for this is to get local channels. As DBS adds local channel service in more areas, presumably customers will reduce their demand for cable service. This is a direct substitution effect. And it is a substitution effect that would not be seen as well in earlier data prior to the passage of the SHVIA in late 1999.

As the Department of Justice and Federal Trade Commission say in their Merger Guidelines

“Market concentration and market share data of necessity are based on historical evidence. However, recent or ongoing changes in the market may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance.”<sup>21</sup>

The strong growth of DBS service in both the national program market as well as in providing competition at the local level provides evidence that any static picture of concentration in programming is bound to provide misleading conclusions.

Indeed, the resulting decline in local market power of cable operators is extremely important in the ways it diminishes cable operators' incentives and abilities (1) to discriminate against unaffiliated programming and (2) to exercise monopsony buying power in a way that adversely affects competition and the flow of programming to consumers. CFA's filing ignores this essential connection between the change in the horizontal structure of the retail MVPD market and the vertical question of monopsony power to which Congress addressed the ownership cap now under consideration.

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<sup>21</sup> DOJ/FTC Merger Guidelines, Sec. 1.521.

***B. CFA misapplies antitrust precedent and misuses price cost margins and the q-ratio in its effort to dispute the increase in retail competition faced by cable operators.***

CFA confusingly tries to apply *PNB*'s analysis of mergers among competing firms to the mergers of non-competing cable carriers. However, the market analysis of *PNB* is simply inapplicable to the cable market: market power over any individual consumer does not change if non-overlapping cable carriers merge. The Court in *PNB* was concerned about a merger that would reduce the number of competing bank branches serving customers and that would thereby increase market power over those customers. Mergers among cable carriers that serve distinct geographical markets have no such competition-reducing effect on cable customers. For purposes of antitrust analysis, the relevant markets for measuring competition and market performance are those in which consumers actually buy, not those in which firms may exist without serving each other's customers. A Wichita cable subscriber cannot buy from a cable operator in Oakland. He can only buy from MVPD providers serving Wichita. So the relevant antitrust market, at least from the standpoint of the kind of merger analysis conducted by the Court in *PNB* is local, not national. CFA cannot point to consolidation at the national level and simply assume that it translates into meaningful consolidation in the local market relevant for antitrust analysis.

CFA makes the same error in its opaque application of the Herfindahl-Hirschman Index (HHI). When entry occurs in a market, a sensible index of market power of firms in that market should not increase. CFA fails to recognize that the merger of non-overlapping cable companies would not change the local HHI (which is calculated by summing the squares of the firms' market share percentages) at all. The index is not a measure of the number of firms that exist in the world, but a measure of the share each

has of markets in which they compete. Suppose there are 5 cable operators in the world and one DBS operator, and that each of those 5 cable operators has 80 percent of the MVPD subscribers in its local market, with the remaining 20 percent being served by the DBS competitor. The “national” HHI for MVPD services in this scenario is 2020. Now suppose that two of the 5 cable companies merge. In CFA’s analysis, this amounts to a decrease in competition because the “national” HHI goes from 2020 to 2668. The error of that conclusion is the failure to realize that the HHI in the local markets—the markets in which firms actually compete to attract subscribers—has not changed at all because the two firms that merged were not competitors. CFA’s implication that alleged increases in the national HHI suffice to show a decline in cable competition at all market levels is thus incorrect. Cable competition has increased at the local level, the level at which the HHI analysis and antitrust precedent cited by CFA properly applies, regardless of what has happened at the national level to which CFA incorrectly applies that analysis.

Another problem with CFA’s antitrust analysis has to do with a misunderstanding of the significance of prices in excess of marginal cost in the market for video services. This error comes up in CFA’s application of the Lerner Index and the Tobin’s  $q$  ratio. Not only does CFA misuse these measures in the local programming market, it also contorts logic to try to apply a local measure to the national programming market.

The Lerner index is a tool that economists use to gauge the degree of market power in an industry. The index is calculated as follows:  $L = (P - MC)/P$ , where  $P$  is price of the good or service and  $MC$  is marginal cost of that good or service. The index essentially provides a percentage mark-up of price over marginal cost. It is important to recognize that the Lerner index starts with the assumption that in a purely competitive

market,  $P = MC$ , so that any increase in price over marginal cost represents a limit to competition and the presence of some market power. Of course, even in the most competitive real-world market, firms charge prices higher than marginal cost. Firms do not enter markets where they cannot recoup their fixed costs and opportunity costs. The Lerner index must therefore always be interpreted with care and a positive mark-up percentage should not necessarily be taken as evidence of poor market performance.

Caution in applying the Lerner index is particularly warranted when the good or service at issue has high fixed costs of production and extremely low marginal variable costs. In such cases, a firm must set prices above marginal cost or else it would never begin to recover its costs of production. Such margins cannot be pejoratively labeled “overcharges” (CFA at n. 83), for without some mark-up the good or service would not efficiently be produced in the first place. Cable television is exactly the kind of good to which this caveat applies. Indeed, as CFA itself acknowledges, program production requires high fixed costs and low marginal costs of distribution (CFA at 32-33). CFA further admits that such economic conditions “are not conducive to vigorous, atomistic, competition.” (CFA at 32) It is thus very peculiar that CFA later tries to argue that the Lerner index is the right tool to measure market power in this market and, moreover, that they can attribute some significance to their finding that the index for cable is 0.54 (CFA p.148). That kind of mark-up over the low marginal costs of cable programming does not in itself show any market power. Indeed, while CFA appears to concede that a mark-up over variable costs is necessary given the cost structure of program production, it then strangely turns around and point to such mark-ups as evidence that the market is performing poorly.



CFA's interpretation of the Tobin's  $q$  ratio is also flawed and directly contradicts the source from which CFA copied the data. CFA relies on data from a paper by Hazlett and Bittlingmayer to claim that Tobin's  $q$  for cable systems is high and has increased recently.

CFA examines the reported increase in the  $q$  ratio and claims "The precipitous rise in the ratio after deregulation strains the credibility of alternative[s]" to the market power explanation. (CFA p. 145) But it seems even further to strain credibility to deny that the rise of the Internet and associated services has been a factor in the market's increased valuation of cable networks. Accepting CFA's explanation would require one to believe that, if the  $q$  ratio has declined since 2000 (the endpoint of the Hazlett and Bittlingmayer data), it is because cable operators are acting less monopolistically. In fact, market values of cable operators have dropped substantially in the past two years and it seems most unlikely it is due solely to unanticipated MVPD competition from DBS providers.

Moreover, CFA's analysis also confuses levels and changes. Why would cable operators have substantially increased their market power from 1998 to 2000? Even an explanation that relies on the passage of the Telecommunications Act of 1996 would require one to believe that investors took two to three years to realize that cable would have increased monopoly power in the video market. In fact, Hazlett and Bittlingmayer lay this out very clearly in their explanation of the graph that CFA copied from their paper. "There is little doubt that the opportunity to add significant broadband access revenues drove this revaluation..."<sup>22</sup> It is clear from the very study that CFA cites to support its Tobin's  $q$  analysis that a substantial part, if not all, of the increase (and

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<sup>22</sup> Hazlett, T. and Bittlingmayer, G., "The Political Economy of Cable Open Access," AEI-Brookings Joint Center for Regulatory Studies Working Paper 01-06, May 2001. p-5. (footnote omitted).

subsequent decrease) in the  $q$  ratio was due to the rise (and fall) of the internet and the expectation of substantial cable modem subscriptions.

The alleged increase in the  $q$  ratio and the markup over marginal cost have nothing to do with any alleged theoretical or real vertical problems. As discussed above, the evidence on these points goes the other way: there is increasing local competition, increasing competition in the program supply market, and less vertical integration.

At the end of its submission, CFA puts forth a section purporting to provide econometric evidence to support its claim that a low horizontal limit is justified (CFA at 191-194). Unfortunately, CFA's application in this section misuses the Lerner index as discussed above and mixes historical elasticities from the *local* downstream level to justify a concentration limit at upstream *national* level. There is simply no theoretical or empirical justification for its confounding of these different markets.

### ***C. Section summary***

Even if one believes that the national cable market has concentrated to the point that monopsony power may exist, one cannot conclude that such power would rationally be exercised absent a finding that the firm with monopsony power also had monopoly power at the local level. For, as soon as there is local competition, the rents to be gained from monopsony behavior can be dissipated through competition and the incentive to exercise such power diminishes. Moreover, the incentive shifts towards obtaining superior programming as a means of attracting subscribers from rivals, behavior directly at odds with monopsony. The evidence convincingly demonstrates that local cable markets have become increasingly competitive with the rise of DBS in recent years. The antitrust

analysis that CFA uses in an attempt to show that the local market is monopolistic is incorrect and provides no results that refute the empirical evidence of competition from DBS.

#### **IV. Conclusion**

In this paper we have tried to make three points that are important to the Commission's deliberations over the question of horizontal ownership limits for cable operators. First, monopsony or other vertical misconduct cannot be simply presumed from national market shares. A more careful analysis of the ability and incentives of a firm to engage in monopsonistic behavior is necessary. When that analysis is done for the cable industry, neither incentive nor ability to harm the programming market through vertical conduct proves at all likely. Even with a very high level of cable concentration the number of subscribers served by others would be in the tens of millions, leaving enormous demand to drive production of diverse, high-quality programming. Competition among MVPD providers, notably between cable and the two DBS providers, makes it unlikely that any would-be monopsonist would want to harm the economic performance of its program suppliers even if it could, for to do so would be to cede an potential advantage to its MVPD rivals.

Second, the empirical evidence corroborates the more theoretical arguments above. The programming market appears to be performing extremely well and directly contrary to the predictions that would flow from CFA's arguments of monopsony and vertical foreclosure. Not only are new program producers regularly entering the market, but the degree to which ownership of such programming is independent of cable

operators directly contradicts CFA's claim that cable operators benefit from discrimination against access by rivals to vertically integrated programming.

Finally, local competition is both on the rise and important to the question of monopsony. Even if one assumes for sake of argument that a large cable operator would have the ability to act as a monopolist, the decline in cable operators' market power at the local level significantly diminishes the likelihood that such a cable operator would have incentive to use its monopsony power. Competition over subscribers would dissipate the rents the monopsonist would expect from driving down its programming costs. Indeed, local competition appears to be driving cable operators to upgrade their systems, expand their offerings, and improve their attractiveness to consumers. As we have argued in detail above, nothing in CFA's misapplications of antitrust precedent, the Lerner Index, or the  $q$ -ratio reasonably calls these findings into question. The empirical evidence of local MVPD competition convincingly refutes CFA's contention that DBS does not meaningfully compete with cable.

The analysis above suggests that performance of the MVPD market is functioning well at the programming level and is becoming more competitive at the retail services level. Nothing in the theoretical or empirical analysis suggests that the likelihood of monopsony harms is anything more than remote even with the presence of an extremely large cable operator at the national level. Taken together, the above three points demonstrate that a stringent horizontal ownership limit on cable operators is unwarranted and is both unlikely and unnecessary to serve the objectives of section 613.

## **EXHIBIT A**



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“Antitrust Implications of EchoStar-DirecTV Proposed Merger,” Stanford Institute for Economic Policy Research *Policy Brief*, November 2001.

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